STRATEGIC PLAN FOR ISLAMIC BANKING INDUSTRY OF PAKISTAN

Islamic Banking Department

State Bank of Pakistan

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Acronyms

1.	AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
2.	ADB	Asian Development Bank
3.	HEC	Higher Education Commission
4.	IBBs	Islamic Banking Branches
5.	IBIs	Islamic Banking Institutions (Islamic Banks, Islamic Banking Subsidiaries and Islamic Banking Branches)
6.	IBs	Islamic Banks
7.	IFSB	Islamic Financial Services Board
8.	IIFM	International Islamic Financial Market
9.	INCEIF	International Centre for Education in Islamic Finance
10.	IRTI	Islamic Research Training Institute
11.	IsDB	Islamic Development Bank
12.	MFB	Micro Finance Banks
13.	MOF	Ministry of Finance
14.	NIBAF	National Institute of Banking and Finance
15.	SBP	State Bank of Pakistan
16.	SECP	Securities and Exchange Commission of Pakistan
17.	SME	Small and Medium Enterprises

Foreword:

"The very objective of the Shariah is to promote the welfare of the people, which lies in safeguarding their faith, their life, their intellect, their posterity and their wealth. Whatever ensures the safeguarding of these five serves public interest and is desirable."

Al-Ghazali

"The basis of the Shariah is wisdom and welfare of the people in this world as well as the Hereafter. This welfare lies in complete justice, mercy, well-being and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the Shariah."

Ibn al-Qayyim

The above stated quotes well summarize the goals and objectives of Islamic Shariah. However, these goals cannot be achieved merely through thoughts and words; concerted efforts are required from all stakeholders. Accordingly there is a need to put in place a social and political system that helps attain goals and objectives of Shariah. Besides, a firm economic system is needed which efficiently optimizes the use of financial resources in an equitable and ethical manner ensuring rewards to all factors of production fairly besides providing for those who do not participate in the production process.

Islamic banking emerged as a response to both religious and economic needs. Islam calls for avoiding any transaction based on Riba while economic needs ask for diversity in the role of banking for promoting investment / productive activities, facilitating economic justice and adding stability to the economy. Islamic banking can thus be perceived as an improved and better equipped system in different dimensions[1].

The banking system in an economy works like the blood circulation system of a body. As only an efficient blood circulation system can ensure a healthy body, similarly an efficient and equitable banking system can dispense economic efficiency and justice. These basic concepts and objectives are common to any banking system whether it be conventional or Islamic. The difference lies in the methodology adopted to achieve these objectives. Conventional banking aims to meet these objectives through use of interest-based contracts while Islamic banking achieves these objectives through trade-based contracts. The later is permissible while former is not. The clear prohibition of interest and permissibility of trade is enunciated in following Quranic verses.

'And Allah has permitted trading, and prohibited riba'

This similarity of objectives and difference in methodology of conventional and Islamic finance defines the regulatory framework required for Islamic banking system. Similarity of objectives implies that a major portion of the regulatory framework would be the same for both the systems. However, the difference in methodology to achieve the objectives requires amendments to existing regulatory system according to the Shariah principles. This is a more pragmatic approach that helps avoid the tendency of unnecessarily reinventing the wheel. Moreover, it gives Islamic banking a great advantage to get maximum leverage out of already existing and well-tested regulatory framework of the conventional banking. The SBP has adopted this approach in line with the standard practice around the world.

[1] http://www.islamibankbd.com/

Governor's Message

The surge in capital inflows in oil rich economies of GCC may have spurred the activity in Islamic Finance but this phenomenon is not the sole catalyst of growth. In fact, the primary driver of growth in Islamic finance is the effectiveness with which the industry is consistently, persistently and substantively being nurtured, groomed and developed in to a viable and authentic alternate means of finance. It is also about how successfully the industry – still evolving in growth phase – is maintaining its robustness, soundness and governance while facing industry specific fundamental issues and challenges.

The comforting and encouraging fact is that Islamic world has collectively launched Islamic finance with a greater degree of commitment with adequate capital backing. This is further supported by the optimal blends of institutional framework that has led to a gradual development of internationally recognized regulatory and accounting frameworks for Islamic finance industry.

Further intensive efforts are underway to aggressively explore and exploit the virtues and benefits of this discipline. As the benefits of Islamic tenets and ethical spirit in finance will unfold, it will offer opportunities for financial innovation and flexibility to structure different types of financial products. This would also allow for a shift from debt-based financial system to an equity-and partnership-based system. Islamic finance has promising potential to channelize wealth through alternate avenues for savings and investments besides financial inclusion of devout Muslims.

Critical driver for effective development, growth and sustainability of Islamic finance industry is the ability of the system to provide assurance to the clients that Islamic financial services delivered to them are in conformity with the injunctions and principles of Islamic Shariah. This will help enhance the outreach and appeal of Islamic finance to the larger Muslim population base, especially among rural and poor populace. It is also critical that the Islamic finance emerges as a robust, competitive, efficient and well-diversified segment of financial industry that can uphold competition with the well established conventional banking industry. Following steps would help evolve and develop a strong, healthy and competitive Islamic financial system:

(i) Further extend and enhance the depth and breadth of Islamic financial system in order to fully appreciate its potential and uniqueness,

(ii) Strengthen policies and supervisory & regulatory frameworks for Islamic finance which not only complement conventional banking system but are also tailored to capture the different types of risks specific to Islamic Finance,

(iii) Recognizing that Islamic finance offers an opportunity to diversify financial system to more equity based and better risk sharing instruments than offered by conventional system thereby helping the overall financial system to evolve in a more balanced way, and

(iv) To better understand and appreciate the richness of Islamic finance, which advocates a different liability and asset management approach. If this approach is effectively applied, it will offer wide range of opportunities for financial innovation–key to the further development and diversification of overall financial system.

It is the recognition and implementation of the above goals and objectives that will lay the foundation for an effective overall financial system.

Valuable experience and lessons learnt by the policy makers and the stakeholders helped in the re-launch of Islamic banking in Pakistan in 2002. SBP's drive to promote Islamic banking as a parallel system, operating at a level playing field with conventional banking, is aimed at building a broad based financial system in the country to enable all segments of the population to access financial services and play their due role in the overall economic development. The growth experienced has been quite remarkable. Based on this successful launch SBP has now put in place a strategy which envisages a 12% market share by 2012, extension of the outreach of financial services in a holistic manner with focus on underserved regions and poor and vulnerable groups, establishing a robust and effective regulatory and Shariah compliance framework with the aim to align our industry with the international best practices and promotion of Islamic financial industry diversification. I hope that the successful implementation of the strategy will help in achieving the outlined objectives thereby contributing towards optimum utilization of the potential that Islamic Finance enjoys i.e. blend economic and social objectives and address the ethical aspects of financing effectively.

Dr. Shamshad Akhtar,
Governor, State Bank of Pakistan

Executive Summary

The recent re-launch of Islamic Banking in Pakistan by SBP has been based not only on the lessons learnt from the history of Islamic Banking efforts in Pakistan but also on the experiences of other countries in the world that are currently known for their lead role in Islamic finance sector e.g.; Malaysia and Bahrain.

The basic difference in SBP's current policies regarding Islamic banking and the previous efforts is the approach adopted by it. SBP has not approached Islamic Banking solely as a religious or a legal issue. It considers it to be more of a change management issue. This basic difference in approach defines SBP's policies on Islamic Banking and is primarily responsible for the success that has been achieved so far. This approach also ensures that there will be no disruption in the current system. The new system will be implemented, tried and tested and therefore would prove its merit on a stand alone basis. The roll out will be market led rather than through legal means or as a religious dictate.

This approach dictates that policies adopted are based on a sound regulatory framework while offering the market to grow in a Shariah compliant manner and at the same time catering to the ever changing needs of the users. This is also in line with the direction and approach being adopted internationally. SBP is focused on providing the users of Islamic banking with the solutions they seek for managing their financial relationships. These solutions will be as functional and cost effective as those being provided by the conventional banking system yet these will be strictly Shariah compliant. To ensure this, there will be need to focus upon two key elements. **Firstly**, a sound regulatory framework that is flexible, market driven and in line with international best practices. **Secondly,** a sound Shariah compliance mechanism which is comprehensive, flexible, multi layered and acceptable locally and internationally.

This essentially forms the basis of our objectives. Our strategy which supports these objectives stands on five pillars which are Extension of Outreach, Shariah Compliance Mechanism, Strengthening of Regulatory Framework, Capacity Building and Internal & External Relations.

With SBP's strategy based on these five pillars the plan is to take the market share from a current level of 4% to 12% by 2012. This will be achieved through increasing outreach in current urban consumer and corporate markets and extending the market to cover new segments of Islamic Micro Finance, Agriculture Finance and SME finance. It is expected that by 2012, Micro Financing, Agriculture Financing and SME financing will account for about 0.3%, 3% and 20% of the total Islamic banks' financing respectively. SBP will continue to strengthen its Shariah Compliance Mechanism through expansion of its Shariah Board, introduction of Shariah inspection for Islamic banks and conventional banks' Islamic banking operations, gradual roll out of AAOIFI Shariah standards and building and use of multiple forums of Shariah experts to ensure innovation in the industry in terms of systems and products that is strictly in line with the sound Shariah principles. SBP will strengthen the Regulatory Framework in line with international best practices by using the sound conventional banking framework as the foundation and then building on it international standards rolled out by international Islamic infrastructure institutions like IFSB, AAOIFI, IIFM etc. A roll out plan for these standards has been put in place. 'Instructions and Guidelines for Shariah compliance in Islamic banking institutions' which cover a variety of areas peculiar to Islamic Banks have already been introduced. Building capacity within SBP and the Islamic banking industry and in this regard focus on establishing a School of Islamic

Economics and Finance of international standard having international affiliation will be a priority. SBP will coordinate and move towards integrating the regulation of Islamic Finance Industry across sectors and across regulatory agencies regulating different areas of this industry. SBP will also play a role in development of Islamic finance industry globally and become one of the main hubs for attracting international Islamic investments.

History of Islamic Banking in Pakistan:

Islam was the basis of creation of an independent state within the Sub-Continent. Since its creation, the people of Pakistan have held the demand for elimination of Riba from the financial system of Pakistan. All Constitutions of Pakistan have incorporated, within the principles of policy, the elimination of Riba as an important objective of the State policy. Quaid-e-Azam, the father of the nation, in his speech at the occasion of the inauguration of State Bank of Pakistan, had expressed the desire for evolving an Islamic system of banking.

Article 38(f) of the Constitution of the Islamic Republic of Pakistan provides: "The State shall …. eliminate Riba as early as possible."

Efforts to Islamize the economy of Pakistan started in the mid 60s. However a significant attempt was made in the mid 80s[2] to convert the banking system to an Islamic banking system. It was a bold and comprehensive exercise. Pakistan was among the three countries in the world that had been trying to implement interest free banking at comprehensive/national level. The Banking Companies Ordinance (BCO, 1962) was amended to accommodate non-interest based transactions and the industry was given a specific timeline to convert to the non-interest based system. State Bank of Pakistan also prescribed for the industry the products which were to be used without any change or exception. Non-interest based banking was rolled out country-wide. In early 90s, the whole exercise was challenged in the Federal Shariat Court which declared some products and processes being used by the banking system un-Islamic. The case was then taken to the Shariat Appellate Bench of the Supreme Court, which upheld the decision of the Federal Shariat Court and gave a detail guideline to fix the issues and a timeline for implementation. Later, the decision regarding transformation of the whole system was set aside in a review petition by the Supreme Court and has been sent to the Federal Shariat Court to start fresh hearings. However, the deferment in the final decision has not dampened the efforts to lay the groundwork for the emerging sector. The Government/State Bank proceeded ahead for promoting Islamic Banking practices parallel with the conventional banking.

Nonetheless, the mid-80s attempt was a significant step in the evolution of Islamic banking system in the country. Technically, it was the most advanced model compared to any other model being practiced anywhere in the world at that time. The efforts and practical steps undertaken in the 1980's to Islamize the economy at national level are considered as pioneering work in the Muslim world as this became important reference material for other countries which undertook the path towards introduction and establishment of Islamic banking systems.

This model was a winner in every sense except for four basic issues. Firstly, it failed to recognize the process as evolutionary as it took the revolutionary approach. Secondly, the system was too rigid and did not offer the flexibility to cater to the ever-changing needs of the dynamic markets. Thirdly, there was no appropriate mechanism to ensure Shariah Compliance. Last but not the least, all the stakeholders, including the regulators, were not ready to play their role when the time came to launch. Unfortunately, these issues could not be addressed adequately and therefore the system fell apart. In any case it has proved to be a valuable experience that has been taken into account while formulating SBP's current strategy to re-launch Islamic Banking in Pakistan.

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[2] Aurangzeb Mehmood, "Islamisation of Economy in Pakistan: Past, Present and Future" Islamic Studies 41:4 (2002).

This re-launch in the country is the result of the decision taken by the Government[3] that irrespective of the fact that the court's decision has been set aside, SBP will launch Islamic banking in the country in letter and the spirit of the earlier court verdict except for two aspects. Firstly, there would be no specific timeline for conversion rather it would be left to the market forces to decide and secondly any disruption whatsoever in the current system will not be allowed till the market is ready for the new system evolving after thorough trial and testing. One of the basic objectives of the launch was also to enhance the depth and breadth of the banking sector by including population that is currently outside the banking system due to its beliefs. As a matter of strategy, we are striving for better preparedness in order to plead the case for Islamic banking more convincingly in future.

Prior to the re-launch, to study the experience of different countries in Islamic banking, a delegation from Ministry of Finance (MoF), led by Advisor to Finance Minister, Dr. Tariq Hassan[4] visited Malaysia, Egypt and Saudi Arabia in September 2001. Based on the recommendations of this delegation and the past experience of SBP, the policies for promotion of Islamic banking were formulated. Accordingly, State Bank of Pakistan issued detailed criteria for setting up of Islamic banks in December 2001. Al-Meezan Investment Bank Limited applied under the criteria issued by SBP to convert itself into an Islamic commercial bank. They were issued a license in the name of Meezan Bank Limited to operate as full-fledged Islamic bank in January, 2002. The bank acquired the business of Societe Generale Bank branches operating in Pakistan and started commercial operations in March, 2002 as a model Islamic bank in Pakistan. In November 2002, in order to allow the scheduled commercial banks to open subsidiaries for Islamic banking operations, a new clause was inserted in sub-section (1) of section 23 of the Banking Companies Ordinance 1962. Consequently on 1st January 2003, State Bank issued detailed policies for promotion of Islamic banking containing Criteria for Establishment of full fledged Islamic banks, Islamic banking subsidiaries and Guidelines for opening of Stand alone Islamic banking branches which was subsequently amended vide IBD Circular No. 2 dated 29th April, 2004. In 2003, an SBP delegation led by Mr. Jameel Ahmed (at that time Director Supervision and currently Executive Director Banking policy Group) also went to Bahrain to study their experience.

To house Islamic banking efforts and activities of SBP in a dedicated place, a separate Islamic Banking Department was established. The department was manned with people that had the necessary skill set. Strategically, this department is positioned to champion the cause of Islamic banking by functioning as the focal point of all activities related to Islamic banking internally at SBP or externally in the industry. The strategy was not only to bring focus but also to have accountability resting in one place for better control and monitoring. Focus, control and monitoring were the three critical aspects as excessive focused effort was required to kick start this industry and at the same time it was essential to ensure that there was no negative fall out as the repercussions would have been serious both in terms of systemic risk and also the case pending in the court.

[3] The President/Chief Executive, in his meeting of 4th September, 2001, had asked the State Bank to take a lead to establish a full-fledged Islamic bank and allow existing banks to open subsidiaries and separate branches for Islamic banking, instead of a full scale conversion of the financial system.

[4] The delegation consisted of Mr. Tariq Hassan, Mr. Khalid Siraj, Mr. Riaz ul Hassan Gilani (currently member of SBP Shariah Board, and Mr. Mahmood Shafqat (JD-Now SJD, IBD).

Current Status of Islamic Banking Industry in Pakistan:

This new initiative has witnessed a very encouraging response. This time there has been a shift in the approach from the legal & regulatory perspective to that of dealing with the whole affair of introducing Islamic banking in Pakistan as a change management issue. As compared to our past experience our new approach provides flexibility to the IBIs as regard to products, instruments and Shariah compliance methodology.

As at end of the year 2003 only one bank operated as a full-fledged Islamic bank and three conventional banks were operating Islamic banking branches. Today there are 6 full fledge licensed Islamic banks (IBs) and 12 conventional banks have licenses to operate dedicated Islamic banking branches (IBBs). All of the five big banks in Pakistan are providing Islamic banking services. The total assets of the Islamic banking industry are over Rs. 225 billion as of 30th June, 2008 which accounts for a market share of 4.5% of total banking industry assets. The market share of deposits stands at 4.2%. Total branch network of the industry comprises of more than 330 branches with presence in over 50 cities & towns covering all the four provinces of the country and AJK. The market share of Islamic Banking (in terms of Balance Sheet) as at end December, 2007 is provided in **Appendix-A.**

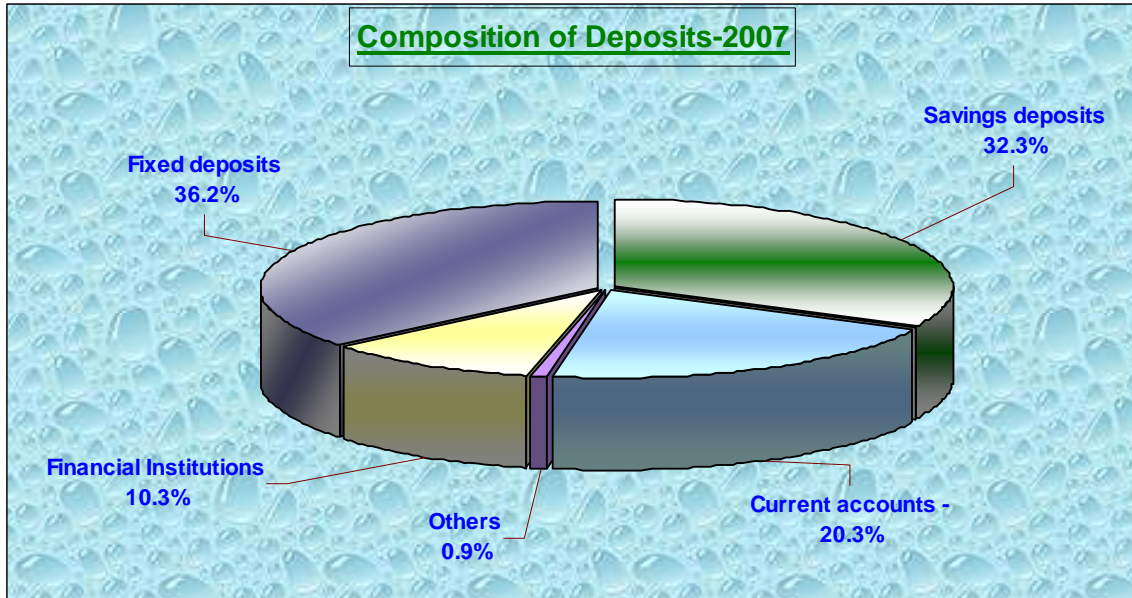
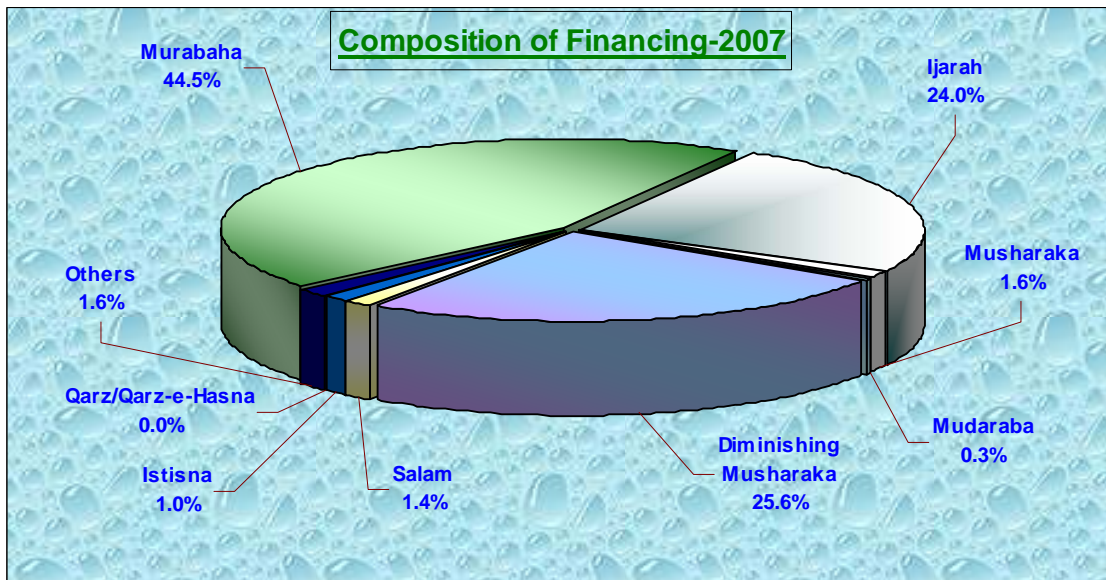
It is also important to compare progress of Islamic Banking in Pakistan with the progress in other countries in order to define an expected path for our industry. Malaysia's first Islamic Bank commenced operations in 1983 and the market share of the Malaysian Islamic banking system today stands at approximately 13%. The Malaysia's official target for the Islamic Banking is 20% market share by 2010[5]. Bahrain's Islamic banking system is said to have gained a share of around 8% in over 30 years. Similarly in Indonesia Islamic banking was introduced somewhere in mid 90's. According to Bank Indonesia, Islamic banking assets reached in March, 2007 to 1.67 percent of total assets as compared with 0.7 percent in 2003 and currently the deposits stand at 1.69% and financing at 2.60% of the total banking sector.[6]

On the other hand, Pakistan has shown much better performance than other global players. The industry progress, during the last five years, in terms of growth in number of institutions, branches, total assets, deposits and financing & investment along with the market share is given in Table below: (Rs in Billion)

Description	Dec.03	Dec.04	Dec.05	Dec.06	Dec.07
Total Assets	13	44	71	119	206
% of Banking Industry	0.5%	1.5%	2.0%	2.8%	4.0%
Deposits	8	30	50	84	147
% of Banking Industry	0.4%	1.3%	1.8%	2.6%	3.8%
Financing & Investment	10	30	48	73	138
% of Banking Industry	0.5%	1.3%	1.7%	2.3%	3.5%
Full fledged Islamic Banks (IBs)	1	2	2	4	6
Branches of IBs	10	23	37	93	186
Conventional Banks with IBBs	3	9	9	12	12
Branches of CBs	7	25	33	57	103
Total Islamic Banking Institutions	4	11	11	16	18
Total No. of Branches	17	48	70	150	289

[5] Bank Negara Malaysia's website

[6] Bank Indonesia, "Islamic Banking Statistics", (April, 2007)

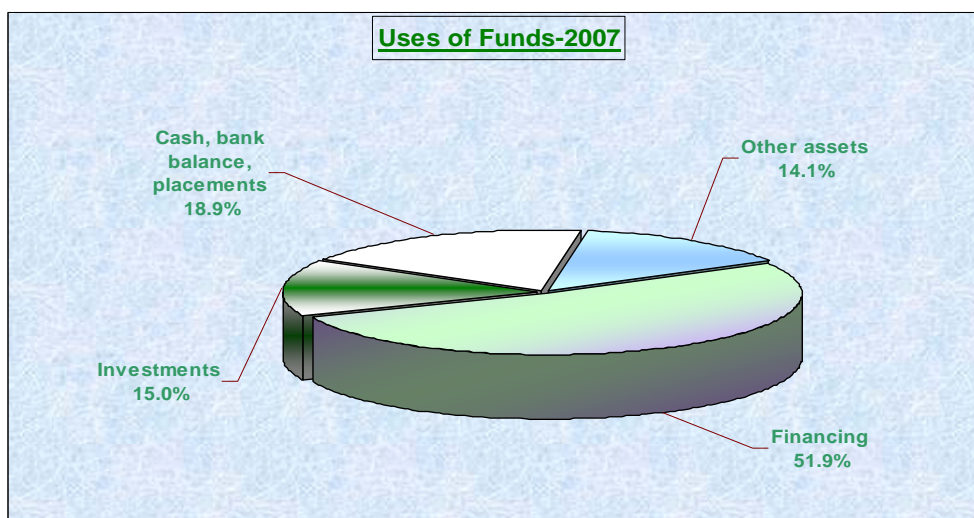
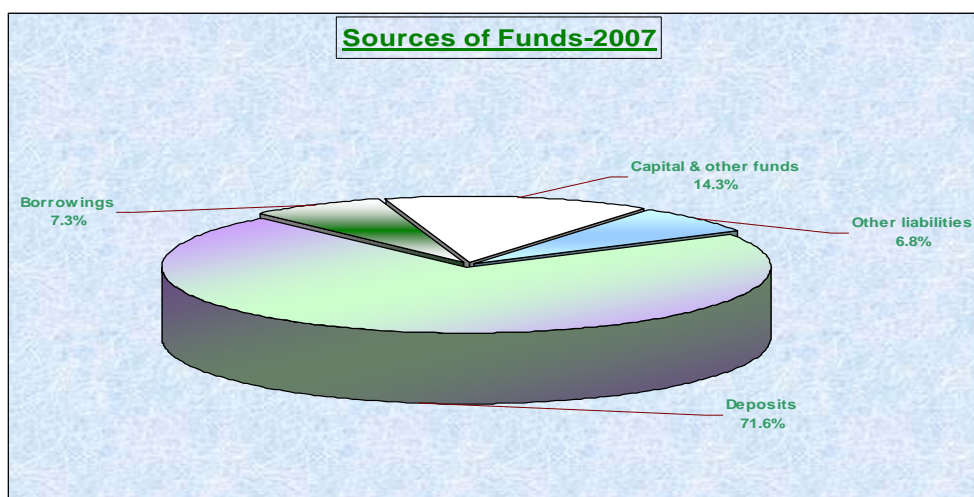
The graphical presentation of composition of deposits and the share of various modes of financings (for end Dec. 2007) is as under:

The savings deposits initially grew at a higher rate but lately the fixed deposits category has experienced a relatively better growth rate. This represents the growing interest of the customers in entering into long term relationships with the industry that is gradually building its reputation as a credible Shariah compliant offering.

For the Islamic Banking Institutions preferred modes of financing belong to the low risk category i.e. those which usually generate a fixed return. Among these, Murabaha (cost plus mutually agreed profit margin) and Ijara (leasing) are the most attractive and popular modes of financing, However, lately the share of Diminishing Musharaka has also grown at a rapid pace leading towards diversification of the Islamic banks' financing portfolio.

Consolidated table of sources and uses of funds in Islamic Banking Sector is as follows:

(Rs. In million)

	2003	2004	2005	2006	2007
Deposits	8,397	30,185	49,932	83,740	147,361
Borrowings	1,899	6,559	9,006	10,843	15,042
Capital & other funds	1,994	5,123	7,811	16,348	29,526
Other liabilities	625	2,276	4,745	8,363	14,017
TOTAL	**12,915**	**44,143**	**71,493**	**119,294**	**205,946**
Financing-Net	8,652	27,535	45,786	65,613	106,848
Investments	1,242	2,007	1,854	7,328	30,961
Cash, bank balance, placements	1,979	11,900	19,314	31,358	38,996
Other assets	1,042	2,701	4,539	14,996	29,141
TOTAL	***12,915***	***44,143***	***71,493***	***119,294***	***205,946***

Source: Annual Audited Accounts

A look at the sources and uses of funds (for end Dec. 2007) shows that the deposits and financing continue to dominate the balance sheet of the Islamic Banking Institutions in Pakistan.

Vision, Mission & Values

Vision

"Develop Islamic banking as banking of first choice in Pakistan, capable of providing leadership to the global Islamic finance industry and facilitating equitable economic growth."

Mission:

"Promote and develop Islamic banking industry in line with best international practices, ensuring Shariah compliance & transparency."

The Values*:*

SBP takes the responsibility for sustainable growth of Islamic banking according to values defined by Islamic teachings. SBP will focus upon Adl, Trust, Fairness, and Honesty & Transparency.

Adl	Equitableness
Trust	Confident expectation of providing excellence
Fairness	Decision free from biasness & injustice, to treat all sides alike.
Honesty	Uprightness and Sincerity
Transparency	Quality of being clear

Objectives:

We have set the following objectives to be achieved by 2012:

1. Achieve a market share of 12%.
2. Expand and extend the outreach of Islamic banking products in existing Consumer and Corporate sectors as well as introduce it in the Micro Finance, Agriculture and SME and other sectors.
3. Strengthen Shariah Compliance framework
4. Strengthen Regulatory framework in line with global best practices
5. Establish a specialized institution to develop Human Resource for the industry
6. Integrate all elements of Islamic Financial Services Industry
7. Be part of the international Islamic banking community, appropriately positioned to attract foreign direct investment

Strategy

To achieve these objectives SBP's strategy will be in line with the general direction being followed globally while taking into account the state of the local industry and innovations that can be introduced.

Pakistan has several comparative advantages in the Islamic Banking space. We have a large population of 160 million people with 97% population being Muslim. This provides a huge domestic market base, second only to Indonesia. Given the fact that our Banking Companies Ordinance, 1962 (BCO) has been amended to suit Islamic Banking principles and concepts, there is a fairly well developed regulatory and legal framework to underpin our current developments. We also have an established institution in the form of National Institute of Banking and Finance (NIBAF) through which a good quality Islamic Banking Certification Course is being offered. Work is also underway towards building a specialised institution for imparting education and training in Islamic Banking. A comprehensive operational Shariah compliance mechanism is in place which allows us a base to further strengthen our Shariah compliance framework. Above all Pakistan's Islamic banking offering has been accepted by all the stakeholders as evidenced by an issueless launch of the recent initiative and the consequent growth in the market. This means that we now have the winning combination and a base that can be used for future development of the industry. Pakistan's Islamic banking offering has also received international acceptance as evidenced by the oversubscription of Sukuk floated in the international market and the number of international players/investors which applied for Islamic banking licenses in the country including multinational banks. This augers well for establishing Pakistan as a good destination for the belief sensitive Foreign Direct Investment, especially from the Middle East.

SBP's strategy takes into account all these advantages and will revolve around the following key areas:

1. Formulate offerings that are comparable and compatible with conventional banking but are in line with Shariah. It is aimed to offer the users same functionality as currently being offered by conventional banking, at similar costs and through similar distribution channels while being Shariah compliant. It will be ensured that Islamic banking offerings are compatible with conventional banking offering so as to leverage, to the maximum extent, the financial and legal infrastructure of conventional banking and also give access to the large balance sheets of conventional banks to Islamic banks enabling them to participate in large transactions and grow faster.
2. Build onto the existing regulatory framework to accommodate Islamic banking transactions by retaining the elements that are common to both systems and adding on those elements that are not currently available to accommodate the unique differences of Islamic banking.
3. Strengthen the Shariah compliance mechanism and position it as being acceptable globally thus helping Pakistan's Islamic banking to integrate well with the global Islamic banking industry.
4. Coordinate with other regulators/agencies to lay the foundation for a consolidated regulatory framework across all sectors of Islamic Financial Services Industry.

Five Pillars of Islamic banking strategy:

To achieve the stated objectives and to capitalize on the strengths, SBP's strategy for promotion of Islamic Banking in Pakistan rests on five pillars:

1. Extension of outreach - both breadth and depth.
2. Strong Shariah compliance mechanism
3. Robust Regulatory framework able to accommodate the unique aspects of Islamic banking transactions
4. Capacity building through human resource development
5. Internal and external relations

1. Extension of outreach

A. Current Status of Outreach:

Currently Islamic Banking is available through 6 full-fledge Islamic banks and 12 conventional banks having Islamic banking branches. The experience as reported by some of these banks is that around 10% to 15% customers walking into their branches are new to banking. These are the people that have remained away from the conventional banking system because of their beliefs. Additionally those who have been using conventional banking but minimizing the depth of their relationship again based on their beliefs tend to deepen their relationship with an Islamic bank thus again contributing to the size of the banking sector from within its existing coverage and base.

Islamic banks are currently able to offer at least 75% of the product range available in contemporary conventional banking. On the consumer banking side, clean lending products like Personal Loans and Credit Cards still pose a challenge. On the corporate side working capital loans are a challenge. None of the banks have any Microfinance or Agriculture business although a few have started offering financing to SME sector. This offers a huge opportunity to extend the reach of the banking sector and multiply the size of Islamic banking geometrically. It also clearly points out the direction that has to be taken.

In the existing coverage area, both geographical and customer type, there is need to enrich the offerings through product development and extension of distribution channel and network. Additionally there is need to extend the coverage to those sectors that are not being covered by Islamic banking i.e. Microfinance and Agrifinance and also to deepen the offerings in the sector with significant potential but limited presence i.e. the SME, infrastructure and housing sectors.

The current break up of financing by sectors extended by Islamic banks vis a vis the total banking system is as under:

	Banking Industry of Pakistan		Islamic Banking (IB) Ind. Of Pak.		Mkt. Share of IB (Percentage)	
Sector	No. of Borrowers	Amount (Rs. Mln)	No. of Borrowers	Amount (Rs. Mln)	No. of Borrowers	Amount
Corporate	26,061	1,520,130	1,959	62,784	7.5%	4.1%
SMEs sector	185,039	437,351	2,685	12,535	1.5%	2.9%
Agriculture	1,415,353	150,777	159	13	0.0%	0.0%
Consumer sector (other than Staff loans)	3,025,463	371,421	36,533	28,843	1.2%	7.8%
Commodity financing	2,616	148,447	31	1,118	1.2%	0.8%
Others	126,021	72,758	11,48	2,459	0.9%	3.3%
Total	4,780,553	2,700,883	42,515	107,752	0.9%	4.0%

Source : Quarterly Reports of Condition for Quarter Ending 31st December 2007

In the above table it can be seen that although Islamic banks have an amount-wise 4% market share in financing, however, their share in number of borrowers is just 0.9%. It is because of following factors:

1. **Products:** 93% customers of banking industry are availing Consumer and Agriculture finance facilities. In consumer finance, a large number of customers are from the credit card or personal loan sectors. However, Islamic banks have no such products and their financing to Agriculture sector is also negligible.

2. **Geographical outreach**: Conventional banks have a network of more than 7800 branches in all parts of the country, through which they can extend financing. However, IBIs being new institutions have just over 330 branches (around 4% of total) as of end July, 2008.

3. **Technical Assistance**: State Bank has arranged technical assistance in the areas of SME, Agriculture, Microfinance, etc. which is being availed by conventional banks through which they are developing products for these sectors. However, no such assistance has been provided to/availed by IBIs as yet.

Despite these issues, it is believed that Islamic banking can grow at a much faster pace than conventional banking. This paper outlines and discusses in detail the specific steps to be taken.

SBP's policies towards Islamic Banking will be:

1. Liberal for branch licensing of IBIs
2. Encouraging and supportive of IBIs in using alternate delivery channels in order to extend their outreach
3. Encouraging foreign Islamic banks to establish Islamic Banks in Pakistan

4. Encouraging the establishment of Islamic microfinance banks
5. Providing enabling environment for IBBs of conventional banks to convert into Islamic banking subsidiaries.

To achieve the target market share of 12%, an increase in coverage of the existing banking segments and entry into new segments of microfinance, agriculture, infrastructure and SME finance will be targeted.

Based on the above direction of SBP's policy and feedback from the industry, following forecast for the industry has been developed:

(Rs. in Million)

	2008	***2009***	***2010***	***2011***	***2012***
Expected Deposit Size	215,938	340,128	499,036	722,109	907,064
Annual Growth Rate	-	**58%**	**47%**	**45%**	**26%**
Expected Financing Size	184,641	277,153	413,594	600,014	731,591
Annual Growth Rate	-	**50%**	**49%**	**45%**	**22%**

It is forecasted that by 2012 Islamic banking deposits will reach in the range of Rs. 900-1000 billion and financing in the range of Rs. 700-800 billion. The growth rates of these deposits are expected to be in the range of 45-60% in next three years. Thereafter the growth is expected to be around 25% as the market would mature having a larger base and greater competition with the conventional counterparts. The IBIs are expected to achieve this target on the basis of channelizing funds from huge untapped markets and supportive role of SBP in regulations and allowing opening of branches in new business places (detail of projection calculations and assumptions is given in **Appendix-A.**

B. Existing Banking Segments

In the existing banking segments the focus will be on:

a. Product development
b. Increase in distribution channels and network

a. **Product Development***:*
In the area of product development different countries follow different approaches. In the Middle East (UAE and Bahrain), product development is left entirely to the providers of the services. This includes the Shariah compliance as well. Sudan is an exception, whose central bank has notified modes of Islamic finance. However, these are not detailed agreements rather abridged versions for providing general direction. In the Far East (Malaysia, Indonesia) the approach is different. Generally, there are varying levels of involvement of the central banks in product development. In Malaysia, Bank Negara Malaysia has not issued any guidelines and approves all the products. Indonesia has incorporated the modes within the regulations rather than as separate guidelines.

SBP's approach to product development is unique and is based on the experience gained from earlier launch of Islamic banking and the Modarabas sector. Given the sensitivity of the general population on all that is positioned on Islam, it was imperative for SBP to have a regulatory role in ensuring the Shariah compliance for all Islamic Banking offerings. At the same time it was essential to provide enough flexibility to IBIs to enable them to respond to the changing needs of

the customers in a timely manner. Therefore the approach adopted by SBP was to develop and notify the 'Essentials of Islamic banking modes of finance' (now part of instructions for Shariah compliance in IBIs) and the related 'Model Agreements'. These are meant to serve as minimum requirements for the Islamic banking institutions and a reference point for SBP for the purpose of Shariah compliance inspection. Following these broad requirements, each bank is free to add features as long as these are approved by their Shariah Advisor. This ensures adherence to Shariah principles and at the same time allows the banks to adjust their offerings in accordance with their customer needs. Currently there are nine models agreements approved by SBP Shariah Board which have been made available on SBP's website (http://www.sbp.org.pk/press/Essentials/Essentials-Mod-Agreement.htm). Going forward three more model agreements will be added (i.e. for Diminishing Musharaka, Istijrar and Wakalah). Work on developing products for Islamically acceptable Treasury bills / medium term Sukuk is also underway. The first Government Sukuk are expected to be launched in September, 2008.

b. Increase in Distribution Channels and Network

SBP will follow relatively liberal branch expansion policies for Islamic banking or at least at par with conventional banking. Based on SBP's projections and the feedback from the industry, following are projections for expansion in the branch network:

Year	2008	2009	2010	2011	2012
Total No. of Branches	436	655	939	1,205	1,351
Annual Growth Rate	-	50%	43%	28%	12%

The IBIs in the next three years will expand their branch network at a faster pace. However, after the year 2011, the growth in branch network is expected to settle down. Although this is an ambitious plan however the industry is comfortable with it and it is also in line with the aspirational market share.

C. Entry into new segments of Micro Finance, Agriculture Finance and SME Finance

To increase the outreach of Islamic banking offerings, the industry will be encouraged to enter the Microfinance and Agriculture sectors, in addition to the SME sector. Some Islamic banks are already focusing on the SME sector and getting a good response from customers. The basic approach to entering these segments would be to maximise the leveraging of the existing conventional banking infrastructure and introducing Islamic banking products through these. SBP will introduce the Shariah compliance mechanism and segregation of Islamic banking business on the balance sheet and income statements. The specific steps planned for each of these sectors will be as follows:

Microfinance:

The central bank will use the conventional Microfinance strategy and focus more on adding the aspects peculiar to Islamic banking. As a first step, SBP has already issued guidelines for offering Islamic Microfinance Services. According to these guidelines various types of institutional arrangements have been suggested for provision of Islamic microfinance services which include:

1. Establishing full-fledged Islamic Microfinance Bank (MFB)
2. Islamic microfinance services by full-fledged Islamic Banks

3. Islamic microfinance services by Conventional banks
4. Islamic microfinance services by Conventional Microfinance Banks

For each type of arrangement, a detailed framework has been provided outlining the systems and controls to be adopted and application procedure as well as different options available to banks/MFBs by which Islamic microfinance services can be offered. Going forward help will be provided to the banks offering Islamic microfinance for developing products through joint forums of experts from SBP as well as the participating banks. Incremental volumes for Microfinance will therefore be ensured. At the same time some conversion is also expected to take place.

Recently announced Microfinance strategy envisions 3 million borrowers by year 2010. It is expected that around 4-5 percent of the borrowers will be using Islamic microfinance facilities. SBP expects that growth in Islamic microfinance will pick up gradually as Islamic banks will expand to new areas after consolidating their position in core sectors like corporate and consumer finance. Moreover, establishment of dedicated Islamic microfinance bank(s) and introduction of Islamic microfinance services by conventional MFBs will give a boost to the sector. The estimated market size has been forecasted as follows:

(Rs. in Million)

Microfinance	2008	2009	2010	2011	2012
Expected Volumes	10	100	500	1,000	2,000
% of Islamic Banking Financing	0.01%	0.04%	0.1%	0.2%	0.3%
Annual Growth Rate	-	900%	400%	100%	100%

Agriculture Credit:

SBP's approach would remain the same as that for other development finance sectors. A task force has been constituted that consists of experts from participating banks and SBP. This committee is in the process of developing products that can be offered by banks undertaking Agriculture credit. These products are expected to be operationally ready by the end of the year. Meanwhile SBP will be issuing guidelines and then regulations for this sector.

Keeping in view the inclination of end users for getting finance through Shariah-compliant products, scope of this market is huge; SBP expects the following volumes from this sector:

(Rs. in Million)

Agricultural Finance	2008	2009	2010	2011	2012
Expected Volumes	370	1,400	4,100	12,000	21,000
% of Islamic Banking Financing	0.2%	0.5%	1%	2%	3%
Annual Growth Rate	-	278.4%	193.0%	193.0%	75.0%

SME Sector:

Similar to Agricultural Finance, entrepreneur in SME sector is more inclined towards using Shariah-compliant products and services provided that required products are available with competitive features and pricing. Currently most of the banks offering Islamic banking products are represented in this sector. Product development is not an issue for this sector as majority of the transactions are Murabaha based. SBP will be developing and issuing guidelines for this sector which will be further developed into regulations. This will be primarily aimed at introducing the elements that are peculiar to Islamic banking and ensuring Shariah compliance. It is estimated that this SME sector will take a share of around 20% in the Islamic banks' financing portfolio by 2012. The expected volumes in this sector are provided in the following table:

(Rs. in Million)

SME Sector	2008	2009	2010	2011	2012
Expected Volumes	27,000	50,000	82,000	120,000	147,000
% of Islamic Banking Financing	15%	18%	20%	20%	20%
Annual Growth Rate	-	85.2%	64.0%	46.3%	22.5%

The extension in outreach will ensure that the targeted volumes are met and that such a growth rate is achieved which is comparable to the best in class jurisdictions. However this growth has to be backed with a strong Shariah compliance mechanism and a strong regulatory framework in order to make it sustainable on the long term basis.

2. Shariah Compliance Mechanism

To ensure Shariah compliance, generally following four major approaches have been adopted by most of the countries regulating Islamic financial institutions:

1. Standardized products defined by the government
2. Products approved by Shariah Board of regulatory authority
3. Products based on international Shariah standards adopted by regulatory authorities
4. Products approved by Shariah Supervisory Boards of respective Islamic financial institutions.

An overview (including Shariah compliance framework) of Islamic Banking industry in various countries especially Malaysia, Bahrain, Indonesia etc. is provided in **Appendices –B & C.**

Pakistan's experience of more than three decades with Islamic banking suggests that an effective Shariah compliance framework is essential for the success of Islamic financial services industry. It is necessary to maintain trust of the depositors and other stakeholders in the Islamic banking offerings. SBP has put in place a comprehensive and robust multi-tiered Shariah compliance mechanism, which has worked well till date testifying to its efficacy and efficiency. This mechanism has been based on the international best practices; our past experience and an innovative approach that best suits Pakistan's market.

It should be appreciated that despite Pakistan's experience of unsuccessful introduction of non-interest based banking, a very detailed and in-depth ground work in the form of various reports, recommendations and judgments is available. These reports have been prepared by various commissions, committees and taskforces comprising experts from various concerned professional fields. A summary of some of these reports is provided in **Appendix-D.**
Our Shariah compliance mechanism consists of three components: (i) a Shariah Board at SBP, (ii) Shariah Advisors in all banks offering Islamic financial services iii) Instructions and Guidelines for Shariah Compliance and (iv) Shariah Compliance Inspection of such banks. SBP Shariah Board has been established by the Central Board of SBP. The Composition, Role, and performance of SBP Shariah Board is provided in **Appendix-C.** Each Islamic Banking Institution (IBI) is required to work under the guidance of a Shariah advisor. SBP Shariah Board has approved Fit & Proper Criteria for Shariah advisors of IBIs. Detailed Instructions and Guidelines for Shariah Compliance in Islamic Banking Institutions have been issued in March 2008 which cover all the necessary elements of a robust compliance mechanism. The essentials of Islamic modes of finance which were previously issued as guidelines have also been made part of these Instructions. Shariah Compliance Inspection of IBIs has also been commenced.

A. Shariah Board

SBP Shariah Board is a Shariah body at national level with a unique composition having two Shariah scholars, one Lawyer, one Chartered accountant and a banker as its members. Its composition is unique and the benefits are enormous. The rulings given by the Board are not only Shariah compliant but are also workable as they take into consideration the legal and financial infrastructure of the country and the business needs. The Shariah Board has been visited by international scholars who appreciated its composition and working and felt the same should be replicated in other jurisdictions.

Given the acceptability of the concept and the outstanding performance of the Shariah Board, SBP is now well poised to take it to the next level. The objectives to achieve at the next level are:

- Increase and broaden the scope of expertise available within the Shariah Board
- Enhance and broaden the Shariah Board to build towards its international acceptance which will not only enhance the image of the country but will also be instrumental in attracting foreign investment

To achieve these objectives, it is planned to:

- Introduce an expert in Islamic Economics as a member of the Shariah Board. It is believed that as the industry gets established and stabilized, it would require the expertise of an economist within the SBP's Shariah Board. This expert will guide the Shariah Board in matters such as establishing benchmarks for pricing Islamic liquidity management instruments and aligning Islamic banking with the national monetary policy management.
- Further strengthen the Shariah Board in a manageable manner both from cost as well as control point of view. SBP will introduce a panel of experts consisting of Shariah scholars of international standing and repute which are at the same time also acceptable locally. The Shariah Board can consult any of the experts on need basis. These Shariah scholars will be part of the panel on an honorary basis and will be consulted at the discretion of the Shariah Board.

Moreover, these initiatives will also to a great extent help the industry in areas like product development & innovation.

The said panel will be used extensively in two areas:

- **Enhancing the credibility and international stakeholders' confidence in Islamic banking efforts of SBP.** A critical area of concern and at the same time opportunity is building of credibility, integrity and confidence of the Shariah scholars around the world and locally. This is a major challenge faced by the industry in Pakistan as well as in other countries. A number of people still consider Islamic banking just a change of nomenclature. Some religious schools (Madaris) either oppose or at least do not favour the present Islamic banking practices on the grounds that it is nothing but another way to attract the people to interest. The efforts at different levels by SBP have addressed the concerns of the local Shariah scholars' community to a great extent. SBP will now use the panel and its association with its Shariah Board to gain the confidence of the international community of Shariah scholars. This in addition to enhancing the image will also make Pakistan's Shariah rulings acceptable across jurisdictions. Thus enabling to further strengthen the ability to attract foreign investment that is looking for Shariah compliant modes.

- **Ensuring Uniformity and Standardization of Shariah rulings (Fatawas).** A common view[7] is that the difference in opinion among scholars is a blessing that promotes ultimate progress. The scholars get rewarded for their honest efforts, even if their views turn out to be inappropriate and need to be revisited. This offers much greater flexibility for Islamic banking transactions. However this also highlights the need for standardization/ harmonization of Shariah rulings especially if cross jurisdiction acceptability is concerned.

Standardization is related to three different areas:

- Standardization of Shariah Rulings or harmonization of Shariah interpretations
- Standardized products and operations of IBIs
- Difference of opinion among Shariah scholars on permissibility of certain modes/ practices like Bai al Dain (Debt trading), Bai al Inah, Tawarruq, Commodity Murabaha

Overall, the Shariah compliance framework has been designed in a manner which aims at achieving standardization not for the sake of it, rather the aim is to have harmonization in the Shariah rulings/procedures etc, which has worked very successfully till date. To address these issues, Shariah standards and guidelines issued by AAOIFI play a very important role. In Pakistan SBP has already put in place Shariah Advisors' Forum which gets industry feedback, reviews, and then adopts/ adapts AAOIFI Shariah standards for eventual roll out in the country. This will create uniformity in the market and align it with international best practices thus making our Shariah rulings acceptable internationally.

B. Shariah Advisors:

Each Islamic Banking Institution (IBI) is required to work under the guidance of a Shariah advisor. To keep this process more objective, broad based and responsive to the market conditions SBP Shariah Board has approved Fit & Proper Criteria for Shariah advisors of IBIs.

According to this Criteria, minimum required Shariah and contemporary educational qualification as well as experience and exposure for becoming a Shariah Advisor has been defined. Moreover, to minimize conflict of interest, it has been specified that a person cannot work as Shariah Advisor for more than one IBI in Pakistan. Further, it has been specified that a Shariah Advisor shall not hold any executive/non-executive position in any other financial institution, except working as Shariah Advisor of Islamic mutual funds of the same IBI. In addition to that, Shariah Advisors of IBIs have been barred from having any substantial interest in or becoming employee of some types of organizations like exchange Companies, corporate brokerage houses or stock exchange. These provisions in Fit and Proper Criteria for Shariah Advisors has ensured objectivity in evaluation criteria, minimization in conflict of interest and induction of new lot of Shariah advisors in the market

C. Shariah Compliance Inspection:

Commencement of Shariah Inspection of IBIs is a major initiative of SBP for ensuring Shariah compliance in IBIs. A leading international firm Ernst & Young from Bahrain and a renowned locally based internationally acclaimed consultancy firm-Ford Rhodes Sidat Hyder & Co. were

[7] *Michael Saleh Gassner,* Developing Common Standards for Islamic Finance, *2006*

engaged to prepare the Shariah Compliance Inspection Manual. The Shariah compliance inspection process covers a review of the Islamic financial arrangements, general banking services and operations, financial statements and accounting records of the Islamic banks to ensure that all their transactions and operations are being carried out in accordance with the injunctions of Islamic Shariah, both in their substance and form.

Before finalizing the inspection parameters and procedures a test case Shariah compliance inspection of an Islamic bank was carried out. Based on this the inspection processes and procedures as given in the manual have been finalized. The consultants have also provided training to SBP Inspection staff for conducting Shariah inspection on the basis of the manual.

Introduction of Shariah Compliance Inspection is among the first attempts by any regulator to start regulatory Shariah inspection of Islamic commercials banks. It is also to mention here that going forward SBP also plans to work on introducing external Shariah Audit practice in the industry.

3. *Strengthening of Regulatory Framework:*

According to Dr. Shamshad Akhtar, Governor State Bank of Pakistan:

"To evolve and develop a strong, healthy and competitive system, Islamic finance industry has to:

- Further explore the depth and breadth of Islamic financial systems in order to fully unleash its uniqueness and potential,
- Develop and implement policies and regulatory frameworks for Islamic finance which are complementary to conventional banking system but which are tailored to capture the different types of risks associated with Islamic finance,
- Recognize that Islamic finance offers an opportunity to diversify financial system to more equity based and better risk sharing instruments than offered by conventional system thereby helping the overall financial system to evolve in a more balanced way, and
- Better understand and appreciate the richness of Islamic finance which advocates a different liability and asset approach that once effectively acknowledged and applied will offer wide range of opportunities for financial innovation key to the further development and diversification of overall financial system.

It is the recognition and implementation of the above goals and objectives that will the lay foundation for an effective financial system."

Without doubt a robust Regulatory framework that is compatible with conventional banking regulatory framework and at the same time recognizes the uniqueness of Islamic Financial system and caters for this uniqueness is the fundamental requirement for promoting and establishing Islamic banking as a financial system that can meet the challenges of the dynamic financial markets and customer needs. This belief underlies SBP's approach to building a sound regulatory framework for Islamic banking in Pakistan. There is no intent to reinvent the wheel. Conventional Banking regulatory framework offers a strong base for developing an Islamic banking regulatory framework. This would therefore be used as a base and focus will be on adjusting certain parameters of the conventional banking regulatory framework and adding a few parameters to recognize and manage the unique aspects of Islamic Banking. It would also be

ensured that developments in Pakistan's Islamic Banking Regulatory framework are in line with the internationally accepted principles so that the regulatory system is also world class and addresses cross jurisdictional issues. This will also help in achieving the goal of being a preferred destination of foreign direct investment that is looking for Islamic modes of investment.

Another aspect of the approach towards building a regulatory framework for Islamic Banking is SBP's desire not to over-regulate this industry so that it can grow at a market driven pace and has room for innovation and diversification while ensuring Shariah compliance.

Keeping these principles in mind, some of the initiatives already undertaken and those that are planned are as follows:

A. 'Instructions and Guidelines for Shariah compliance':

To cater to the unique aspects of Islamic banking, in addition to providing detailed guidelines for establishing full fledged Islamic Banks, Islamic Banking subsidiaries and Islamic banking branches, one of the major initiative taken by SBP has been the preparation of 'Instructions and Guidelines for Shariah compliance in Islamic Banking Institutions', which have been issued in March 2008.

The 'Instructions for Shariah compliance in IBIs', cover various areas related to appointment, removal and working of Shariah Advisors; conflict resolution in Shariah rulings; Shariah compliant modes; use of charity fund, introduction of new products and services and schedule of service charges etc. It is to mention that essentials of Islamic modes of financing, earlier issued by SBP through a press release on April 15, 2005, have now been augmented and made part of these instructions. Furthermore, State Bank of Pakistan through these Instructions has specified Shariah compliant modes of banking and finance for IBIs in exercise of the powers conferred under the BCO.

The 'Guidelines for Shariah compliance in IBIs' are meant for providing guidance in areas like Shariah compliance, internal Shariah audit, investment in shares, policy for profit distribution with PLS account holders and financial reporting and general disclosure etc. Necessary flexibility has been provided in these guidelines and IBIs can set up the suggested systems and procedures keeping in view the size and scope of their operations. These guidelines have been issued on "comply or explain basis" and IBIs shall record reasons in writing for noncompliance with any of these guidelines.

B. Issuance of Guidelines for Microfinance/Agricultural Financing:

To support the extension of outreach in new banking segments, SBP has issued Guidelines for offering Islamic microfinance services. These guidelines have been issued after taking feedback from the stakeholders.

Similarly a task-force on Agriculture finance has been setup which will give its recommendations for various Shariah compliant Agricultural products and services. On the basis of recommendations of this task force, SBP will prepare guidelines for Islamic Agricultural finance, which will then be passed through the process of public exposure and feedback before issuance.

C. Rolling out International Standards (IFSB & AAOIFI):

To introduce world class regulations and be part of the global Islamic banking industry SBP will focus on rolling out regulatory standards set by international bodies like Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM) & Accounting and Auditing Organisation for Islamic Financial Services (AAOIFI).

i. Rolling out IFSB Standards

IFSB has developed and continues to develop various standards for Islamic Banking industry. These standards are formulated by a panel of experts and have been vetted by all central banks regulating Islamic banking across the globe.

The State Bank of Pakistan has put in place a process to introduce these standards in Pakistan. This process includes public exposure to draft regulations and an exposure and buy-in of the stakeholders of this industry. After necessary adjustments, based on the feedback, our laws and other regulatory considerations these standards will be rolled out. The standards/guidelines issued by IFSB are currently in the different stages of the process for roll out in Pakistan. IFSB has a schedule for rolling out the standards (SBP is dove tailing into this schedule and introducing these standards as and when these are issued by IFSB)which is given as follows:

Tentative Roll out Plan of IFSB Standards/Guidelines

S. No.	Name of the Working Group	Status	Roll out Date
1.	Risk Management	Standard Issued	September 2007
2.	Capital Adequacy	Standard Issued	December 2008
3.	Corporate Governance	Standard Issued	June 2009
4.	Transparency and Market Discipline	Standard Issued	June 2009
5.	Supervisory Review Process	Standard Issued	June 2009
6.	Special Issues in Capital Adequacy	Under Process	Within Two years of issuance of final standard
7.	Market Conduct	Under Process	Within One year of issuance of final standard
8.	Shariah Governance	Under Process	Within One year of issuance of final standard
9.	Governance of Islamic Investment Funds	Under Process	To be implemented by SECP
10.	Corporate Governance of Takaful Operations	Under Process	To be implemented by SECP

ii. Rolling out of AAOIFI Standards

A process similar to rolling out of IFSB standards has been put in place for rolling out AAOIFI Shariah standards. SBP plans to introduce Shariah standards for various modes of financing after necessary amendments. This will create uniformity in the market and align it with international best practices thus making our Shariah rulings acceptable internationally. A roll out plan of AAOIFI Shariah standards is as follows:

Roll out Plan of AAOIFI Shariah Standards

S.No.	Shariah Standard	Roll out Date
a)	Murabaha to the Purchase Orderer	By December 2008
b)	Ijarah and Ijarah Muntahia Bittamleek	
c)	Investment Sukuk	
d)	Default in Payment by Debtor	
e)	Sharika (Musharaka) and Modern Corporations	
f)	Guarantees	By December 2009
g)	Mudaraba	
h)	Conversion of a Conventional Bank to an Islamic Bank	
i)	Salam and Parallel Salam	
j)	Qard (Loan)	By December 2010
k)	Istisna' and Parallel Istisna'	
l)	Dealing in Currencies	
m)	Debit Card, Charge Card and Credit Card	
n)	Settlement of Debts by set-off	By December 2011
o)	Transfer of debts	
p)	Jua'la	
q)	Financial Paper (Shares and Bonds)	
r)	Documentary Credit	By December 2012
s)	Commercial Papers	
t)	Possession (Qabd)	
u)	Sale of Commodities in Organized Markets	

In addition to Shariah standards, AAOIFI has also issued Accounting standards for Islamic Banking transactions, rolling out of which is being carried out by ICAP and SECP with active support from SBP. So far two accounting standards for Murabaha and Ijara have been issued and notified by SECP. Work is in progress on standards for Profit Distribution to PLS depositors, Diminishing Musharaka followed by Musharaka. We also plan to adapt/adopt standardized contracts for inter-bank dealing and investments introduced by IIFM which will provide a degree of harmonization in the industry.

The rolling out of these standards will help SBP in not only building a robust Islamic Banking regulatory framework but would also help us in addressing critical areas like Risk Management and Governance.

D. Developing Specific Rating Standards for Islamic Banking:

Risk profiles of Islamic banks, albeit being a commercial bank, is different than their conventional counterparts in various aspects[8]. At the core, risk profile of an Islamic bank

[8] Fitch Rating Agency: Islamic Banking – Factors in Risk Assessment, March 2007

is the same as with a conventional bank i.e. examining the financing/lending policy, risk diversification practice and a general assessment of the prudence of management etc. There are, however, some specific issues like transparency, profit sharing mechanism for PLS account holders, market risk, rate of return risk, Shariah compliance risk, funding, liquidity and corporate governance which have to be evaluated while assigning credit rating of Islamic banks.

So far, Islamic banks are being evaluated using similar criteria as that for conventional banks. SBP plans to encourage and guide the rating agencies to develop specific rating standards for Islamic banking. The rating agencies have shown a keen interest in doing so. They are at a different stage of introducing rating exercise for Islamic banking institutions. They have been part of IFSB working group for rating agencies and are in the process of developing standards based on IFSB standards and the international experience of their own affiliates.

It is to also mention here that one of the major benefits of the availability of Shariah ratings as a tool is to make sure that the competition, which is useful and necessary, will lead to the improvement of Shariah compliance. It will not happen unless a mechanism for such assessment of legitimacy and its disclosure to the public is in place.

4. Capacity Building

Islamic finance calls for a different mind set. Intellectual capacity building is direly needed for research, academia, policy makers, central banks & other regulatory authorities, financial institutions, auditors, rating agencies, financial managers and lawyers & judges etc.

Fast growth in the Islamic banking has accentuated the need for developing human resources for this sector, which is a challenge task. This is because human resources in this segment need to be well versed with conventional banking practices as well as Islamic banking and must be able to understand and communicate the difference between the two. Given that there is a religious background to Islamic banking there is also a need to understand the basic percepts of Islam in relation to financial transactions.

The requirement for better-qualified personnel has increased particularly in Product Development, Risk Management, and Shariah Compliance/Audit etc. Islamic banks' personnel must be proficient in conventional banking operations and product structuring and they should be able to explain to customers the differences between Islamic and conventional product structures. The demand for Islamic banking and finance education and training has increased and the number of institutions providing higher education and training for Islamic banking and finance is also increasing[9].

In Pakistan, keeping in view the increased number of branches and expanding networks of Islamic banking institutions, there is a need to address the critical issue of developing human resources at multiple levels for this sector. Based on the requirements of the Islamic banks a detailed forecast of human resources for Islamic banking industry has been developed and provided in **Appendix-A.** Consolidated position of human resource requirements in Islamic banking industry by year 2012 is as follows:

[9] Simon Archer & Rifaat Ahmed Abdel Karim, "Islamic Finance-The Regulatory Challenge", 2007

Human Resource Requirement	2008	2009	2010	2011	2012
No. of employees	9,601	13,063	16,181	19,220	20,953
Annual Growth Rate	-	36%	24%	19%	9%

Human resources required for this industry will be more than 20,000 by 2012 as compared to around 8000 currently available. Based on international best practices the 20,000 employees needed by 2012 in Islamic banking would mean 1% or 200 senior managers, 15% or 3000 mid level managers and 84% or 16,800 front line or field staff. This defines the capacity needed for developing the different levels of human resources.

Several universities in Western and in Muslim countries offer specialization in Islamic finance within general graduate and postgraduate programs (for example, the University of London, Monash University Malaysia, Webster University, USA, International Islamic Universities in Malaysia and Pakistan, University of Loughborough, UK). Several institutions (e.g. Institute of Islamic Banking and Finance (IIBI), UK, Netversity.org, National Institute of Banking and Finance (NIBAF), Pakistan) etc. are also offering certificate and diploma courses. However, most of these are not focused in terms of specific industry requirements as they provide general education in the field of Islamic banking and economics.

In order to meet the specific requirements of the industry that focus on relevant areas at multiple levels, there is a need to have a specialized institution in the country that caters to the specific industry requirements and is structured to provide focus in specific areas apart from imparting general education in Islamic banking and economics. Given that SBP is the main driving force behind development of Islamic banking in the country, it is planned to establish *An Institute of Islamic Banking and Economics* to facilitate the industry in developing the human resources which it needs to run this industry on a sustainable basis. The aim is to establish this institution in collaboration with an International Education Institution of high standing and repute. As a first step research has been initiated through Asian Development Bank to help determine the specific industry needs in the area of human resource development. Based on the findings of this research, the objectives and terms of reference of this institution will be developed which will be used for developing a feasibility of the project together with acquiring collaboration with the right type of international education institutions. Assuming the research and feasibility report support the establishing of such an institution the necessary work will need to be carried out on a fast track basis. A period of two years is being aimed at in which to establish and start operations of this institution.

Apart from building an institution through SBP's support, there is also need to encourage different universities and educational institutions to offer certification courses in Islamic banking to allow the industry multiple channels to meet their human resources development needs. Also, there is a greater need and scope for private sector participation and efforts in this field. However, a critical area that must be managed is the quality of education and training being imparted at such institutions. In this regard a team within the Islamic Banking Department of SBP developed a standardized curriculum for certification, post-graduate and master level programs in Islamic Banking. The curriculum has been sent to the Higher Education Commission (HEC). HEC's Curriculum Review/Revision Committee would in due course consider the curriculum for possible adoption in Pakistani educational institutions. This attempt will hopefully ensure up to a certain extent the quality of the offerings by education, training and research institutions offering Islamic Banking courses.

Further, in view of rapid branch network expansion, in the short run, SBP plans to work on expanding the outreach of the currently offered (3 weeks) Islamic finance training through NIBAF by working in collaboration with those banks that have training infrastructure available at cities other than Karachi and Islamabad. It is to mention here that the aforementioned course is being widely appreciated by the stakeholders both in terms of coverage and quality of content.

Similarly, keeping in view the dire need of having a steady supply of quality Shariah personnel to the industry coordination with NIBAF & industry players will be enhanced to provide adequate training facilities to the current & prospective Shariah advisors/personnel.

5. Internal and External Relations

Apart from Islamic banking, the Islamic financial industry of Pakistan also includes Shariah-compliant mutual funds, Modarabas, Sukuk market, Takaful companies, Islamic asset and wealth management companies, Islamic Pension Funds, etc. Although capital markets form an integral and important part of this market but given the fact that SBP has been driving the Islamic banking efforts aggressively over the past few years, it is seen as representing Islamic financial Industry. These non bank Islamic financial institutions are being regulated by Securities and Exchange Commission of Pakistan (SECP). Therefore, it becomes extremely important for SBP to address the cross sectoral issues in the Islamic financial industry when it is being regulated by two separate and independent regulatory bodies. To achieve this, there is a need to have a holistic view of this industry for providing Shariah compliance and regulatory framework, so that different sectors in this industry are not regulated by divergent regulatory standards and practices. In absence of close coordination and cooperation between the two regulatory bodies, the Islamic financial industry runs a reputation risk which if not managed well will destroy the credibility of this industry.

A. Interaction with internal stakeholders:

Focus on addressing cross sectoral issues of the Islamic finance industry will be based on the two points highlighted by the Governor of SBP in her address at IFSB Conference on May 15, 2007.

"Shariah compliance issues further necessitate taking a more aligned view across IF Businesses, as users of Islamic products may be oblivious of Ideological differences as well as varying perceptions and interpretation of the Shariah advisors or boards and or regulators. "

"Traditionally different segments have been regulated by their specialized supervisory authorities. These authorities have adopted risk management principles and supervisory stances which are strictly in line with the risk profile of their supervised sections in isolation. With section integration the supervisors have to coordinate closely in both their policy formulation and regulations as well as onsite supervision, they have to coordinate creation of the necessary firewalls, remove moral hazards and govern the degree of cross segment exposure. This may even call for institutional restructuring through merging various supervisory bodies into a single entity or for closer coordination between the supervisors through creation of a third coordinating body."

As elaborated by the Governor, SBP will focus on areas of Shariah compliance and close coordination for cross sectoral approach towards regulation and supervision of the Islamic financial industry.

i. Common Forum for Shariah Compliance:

SBP has already put in place a rigorous Shariah compliance framework including its Shariah Board, Issuance of Instructions and Guidelines for Shariah compliance, model agreements for Islamic modes of finance, Fit and Proper Criteria for Shariah Advisors in Islamic Banking institutions, introduction of Shariah compliance inspection etc. Similarly it has addressed the issues of conflict of interest by limiting the number and type of financial institutions in which a Shariah Advisor of an IBI can work. However, SECP neither has any "benchmark standards against which to assess Shariah standards adopted by its industry which could be quite at variance with the practices of Islamic Banks[10]". Furthermore close coordination between two regulators will be required for addressing the issues of conflict of interest.

To address aforementioned issues and ensuring a shared approach in Shariah rulings, the two regulators have formed a Joint Forum for discussions and decisions. In this regard SBP may give SECP access to its Shariah Board for obtaining rulings related to Capital markets and products. SBP will also offer SECP access to its Shariah Advisors' Forum and invite them to be part of Shariah committees where Capital market products/issues may arise.

ii. Close Coordination in Policy Formulation and Regulations:

In recognition of the need of a cross sectoral approach towards the rapidly growing Islamic financial sector of Pakistan; the two regulators shall work through the abovementioned Joint Forum for close coordination for policy formulation, regulations and on-site supervision. They shall provide the requisite emphasis for resolution of issues that entail harmonized regulatory and supervisory approach. These efforts will focus on collaboration not only through the sharing of information, but also through the harmonization of prudential and market-conduct rules and the adoption of consistent Shariah governance framework.

Moreover, they shall ensure synchronized efforts for rolling out and implementation of the guidelines and standards in their respective financial sectors, issued by various International Islamic Infrastructure Institutions like IFSB, AAOIFI and IIFM etc.

Work upon framing a "Strategy for Development of Islamic Financial Services Industry of Pakistan" would also be initiated. Efforts shall also be made to encourage collaboration between the two through conferences, workshops, symposiums, training programs, seminars or any other events relating to Islamic finance to cultivate human capital in both the regulators.

iii. Provision of Level Playing Field

[10] Dr. Shamshad Akhtar, Address at IFSB Conference, May 15, 2007

Another area of importance for the industry is the issue of "**level playing field**". This basically entails three areas of concern. First is the taxation issue, second lack of liquidity management instruments and third fiscal or financial incentives to promote the industry.

Various types of incentives have been provided by different countries for the promotion of various sectors of Islamic financial industry including Islamic banking, Islamic capital markets and mortgage financing etc.

Malaysia has taken a lead in providing level playing field and offering various incentives to the players in Islamic finance industry. Some of these incentives[11] are: providing tax neutrality for Islamic financing transactions, real property gains tax and stamp duty; 10-year tax exemption to Islamic banks on income derived from Islamic banking business conducted in international currencies including transactions with Malaysian residents; treating profits received by the Islamic banks on Islamic financing like interest income for taxation purpose; treating and taxing profits from Islamic banks similar to interest received; exempting Musharaka partners from filing of separate tax returns and decreasing stamp duty by 20% payable under Islamic financing etc.

Similarly, United Kingdom[12] has allowed changes in stamp duty land tax (SDLT) for Murabaha; more SDLT provisions for Ijara and Diminishing Musharaka for mortgage financing; equating Murabaha and Mudaraba transactions for tax purposes to their traditional banking counterparts; treating purchase price payable under Murabaha as the principal amount of loan and taxing "Sukuk" at par with conventional debt securities etc.

Singapore[13] has also waived the double imposition of stamp duties on Islamic real estate financing and tax treatment for Sukuk has been the similar to conventional bonds.

An elaborated description of tax incentives to Islamic Banking Industry in these countries is provided in **Appendix-E.**

SBP has been active in helping the industry resolve the **taxation issues.** A comprehensive process is in place that provides the necessary groundwork to all the government departments concerned to enable them execute their part of the change in rules. This process consists of forming a committee at Institute of Chartered Accountants of Pakistan (ICAP) that determines the accounting treatment of Islamic transaction modes. Based on the accounting treatment, changes needed in the tax rules to provide same effective taxation treatment to Islamic transactions as that provided to conventional transactions, are identified. These changes and the detailed rationale are then provided to all the relevant government departments. Follow up is made with these departments by SBP till the rules are changed. This is a very effective process and has worked well through which accounting treatment for Murabaha and Ijara modes were recommended to SECP. SECP has notified these treatments for the industry to follow. Federal Board of Revenue was approached for the necessary changes required from the taxation point of view. These have been made by CBR. In the Finance Bill 2007 it has now been ensured that taxation of Shariah compliant Islamic banking would be treated at par with conventional banking.

For **liquidity management,** State Bank of Pakistan has formed a Task Force to map out a plan for introducing short term and medium term liquidity management products based on innovative

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[11] The 2007 Budget Speech of Prime Minister and Minister of Finance, Malaysia

[12] Norton Rose, April, 2005.http://www.nortonrose.com/UK Budget 2007

[13] http://www.mas.gov.sg/news_room/statements/2007/Opening_Remarks_By_Mr_Ng_Nam_Sin.html

Islamic Structures. It prepared a structure for Shariah-compliant Government of Pakistan Sukuk, which after approval from the Ministry of Finance, Government of Pakistan, have been recently launched. With the introduction of GoP Ijara Sukuk, liquidity management and SLR issues of the Islamic banking industry of Pakistan will get resolved to a large extent.

Development of the Inter-bank money market is an area currently being worked upon for which a working group has been established within SBP to develop products/ agreements for clean and secured interbank transactions.

Fiscal and financial incentives to promote an industry are a fairly accepted phenomenon. It is not peculiar to Islamic banking. It has been done in the past for different industrial sectors and is currently being done as well. For example, to promote micro finance banks, tax exemption on income for five year has been provided as an incentive. Incentives for Islamic banking industry therefore can be considered since the Government would like to promote this industry. SBP has already provided some incentives to IBIs in the form of relaxations in rules to compensate them due to scarcity of Shariah-compliant liquidity instruments for investment and SLR purposes. These include lower SLR requirements both for Pak Rupee Demand and Time Liabilities and Foreign Currency FE-25 deposits. Moreover, IBIs have been given enhanced limit by SBP for investment in shares. In addition to these "compensating" incentives, SBP had earlier waived the annual branch license renewal fee for Islamic banking branches, applicable on conventional banks' branches. However one needs to be very careful in giving incentives to this sector as it may have unhealthy effects on the overall banking sector. Additionally the recent growth in the industry suggests that further incentives at this point in time may not be required. Since the industry is nascent and the central bank wants to ensure a sound foundation for it, there is need to manage its growth. Fast growth without an adequate regulatory backup may cause serious problems in the future. Therefore SBP is not envisaging any specific incentives for this industry other than the relaxations already given. Incentives may be considered, if at all required, in the future.

Further SBP will keep on reviewing existing laws for amendment and/or introduction of new laws which fall under its purview. Another important area to work upon is efficient resolution of recovery cases relating to Islamic banking through the Judiciary. As part of this strategy, SBP plans to take up this issue in a manner wherein through study of other countries' systems & coordination with stakeholders, an appropriate course of action would be adopted. Two of the alternative proposals in this regard include use of the existing judicial system by imparting training in Islamic finance to judges and lawyers and the other is establishing separate & parallel recovery courts/benches for the Islamic banking sector.

SBP will also encourage the Islamic banking Institutions to form their own Association for taking up their urgent & important issues at different levels with relevant authorities.

SBP will attempt to further expand the scope and increase the effectiveness of abovementioned efforts (being made to provide the industry with a level playing field) by working for establishment of a high powered forum consisting of all important stakeholders such as SBP, SECP, MoF, CBR & other relevant ministries and Islamic financial infrastructure institutions.

B. Interaction with external stakeholders:

In the global context, a number of institutions have been established to act as focal points on major issues in the field of Islamic finance, in particular the Islamic Financial Services Board (IFSB), Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA), International Islamic Financial Market (IIFM), and Islamic Research and Training Institute (IRTI) are some noteworthy ones. SBP plans to further improve its coordination with these institutions and also other multilateral institutions like IsDB, ADB etc. and with different central banks, in order to strengthen the Islamic banking industry in Pakistan. This would also help in attracting more foreign investment in the country because active support from these institutions would play a catalytic role in the confidence building at international level.

Being one of its founding members, SBP is already playing an active role in the working of the IFSB. A number of individuals from Pakistan, i.e. from SBP and other institutions, have been nominated by SBP to work in different capacities. In the 9th meeting of the Council of the Islamic Financial Services Board (IFSB) held on 29th November, 2006 in Jeddah, the Council approved appointment of Dr. Shamshad Akhtar, Governor, State Bank of Pakistan as the Deputy Chairperson of the IFSB for the year 2007. Furthermore, Dr. Akhtar is holding the position of Chairperson of the IFSB for the year 2008.

SBP is also a permanent member of the International Islamic Financial Market (IIFM) and is being represented through active participation in its meetings of Board of Directors, Working Groups etc. SBP has also been actively collaborating with central banks of other countries like Malaysia, Bahrain and Indonesia. In this regard MOUs have been signed with central banks of Malaysia and Bahrain for the promotion of Islamic banking and for coordination in different areas including supervision, training and sharing of technical expertise.

In order to further improve SBP's interaction and relations with the external stakeholders following initiatives have been planned:

- Seek technical assistance from IRTI/IsDB for education, trainings, research, conferences, and other related matters.
- Conduct Islamic banking & finance trainings in Pakistan in association with INCEIF, Malaysia.
- Support IIFM by participating in their working groups and other related activities.
- Encourage Islamic banks and other Islamic financial institutions/associations like Takaful companies; Modaraba Association, stock exchange(s) etc. to become members of IFSB, in coordination with SECP.
- Maintain a close liaison with IFSB and its various working groups, Technical Committee and Council.
- Seek technical Assistance from IFSB regarding various researches/impact studies e.g. impact study on IFSB's Capital Adequacy Standard in Pakistan.
- Actively participate in various task forces, working groups etc of IFSB for better understanding of IFSB's Standards/guidelines and other current issues.
- Facilitate the arrangements for IFSB's meetings and other events in Pakistan including upcoming meetings of General Assembly and Council of IFSB.

C. Create awareness of SBP Islamic banking efforts among different stakeholders in Pakistan:

Islamic banking has a charred history in Pakistan. The failed attempt of the 80s has created deep skepticism about Islamic banking practices in the country. These negative perceptions also adversely affect our current initiatives. Our stakeholders including some of the religious scholars, bankers, academicians and general masses are skeptical about the re-launched Islamic banking in Pakistan. It is important to address this issue to establish the credibility of our Islamic banking initiative and ensure the growth being envisioned and planned.

To address this issue, SBP had initiated an awareness campaign based on holding a series of interactive seminars with some of the key stakeholders including the SBP staff. Seminars were held and presentations made to various departments of SBP and offices of SBP (BSC). Similarly seminars were held for prospective banks, chambers of commerce & industries, business houses, etc. Lectures in various training and educational institutions like IBP and universities like International Islamic University Islamabad, Bahria University and Karachi University etc have also been made. Moreover, SBP has participated in various talk shows and interviews on a number of TV channels. SBP has also tried to ensure press coverage of significant events and conferences being held in Pakistan. One part of the strategy has been to target decision makers i.e. the military and civil bureaucracy and regular presentations have been made in civil services academy and staff colleges.

In addition to continuing and enhancing all these efforts, SBP in coordination with Industry players will take following measures:

- An industry wide campaign in mass media especially through television promoting Islamic banking as a whole highlighting its differentiating features as well as benefits.
- Starting special outreach program by which SBP will arrange seminars and lectures, in collaboration with Islamic banks and local chamber and trade associations, in various cities of Pakistan targeting business community and general public at large. Active participation and presentation by local religious scholars in such gatherings shall also be encouraged.
- Moreover, SBP will prepare, in collaboration with Islamic Banks, various brochures in English, Urdu and local languages, highlighting in a simple manner various Islamic Banking products and services, their salient and distinctive features as well as their Shariah related aspects. Availability of these brochures in all the Islamic banking branches in Pakistan will be ensured. To start with SBP has prepared comprehensive FAQs on Islamic banking which will be published and distributed through Islamic Banks.

Conclusion:

Embark upon an action after careful thought. It is a folly to say,
Let us begin the task now and think about it later
Unless painstakingly performed, a task will not succeed
Even if men in Multitudes support it
Tirukkural 47: 466-468

The success of the present re-launch of Islamic Banking in Pakistan by the State Bank of Pakistan has been a result of careful planning and hard work. The results prove that the strategy for introduction of Islamic banking in Pakistan has worked well. The growth has been impressive by any standards. Achieving a market share of 4.5% in about 5 years in a rapidly growing banking sector is a remarkable accomplishment compared to the best in class countries. The re-launch experience has been invaluable and serves as a strong base on which the strategy has been put in place.

SBP's goal remains to establish Islamic banking in the country as a parallel banking system comparable and compatible with the conventional banking system while being Shariah compliant. SBP will now take its efforts to the next level. We will extend its outreach. This will be done by expanding the branch network in the existing banking segment and extending further into newer segments of Micro Finance, Agriculture Finance and SME Finance. SBP will strengthen the Shariah compliance mechanism by extending the membership of SBP Shariah Board and supporting it with a larger panel of internationally recognized Shariah consultants. It will further strengthen the regulatory framework by introducing guidelines for the new segments the industry will enter into. At the same time SBP will continue to build upon the existing regulatory framework through introducing standards developed by international bodies like IFSB, AAOIFI and IIFM. It will undertake a focused effort on developing human resource of this industry and would establish a center of excellence for training and education in the field of Islamic Banking and Economics. Cross sectoral regulatory aspects will be addressed through the Joint Forum of SBP and SECP. SBP will continue to help the industry resolve its issues of taxation and liquidity management

It is strongly believed that the strategy presented will not only spur the growth of Islamic Banking industry but will also provide it with the robust regulatory framework it needs to become a sustainable industry. It will help us establish as one of the leaders in Islamic banking internationally. It will also help us attract belief sensitive foreign investment.

....وَ اِلى اللّٰہِ عاقِبۃُ الأمور
.....and unto Allah is the end of all matters سورة لقمان (31:22)